europeaninstitute

Bulgaria and the European Economic and Monetary Union

Associate Professor Lena M. Roussenova, PhD

European Economic and Monetary Union

The European Economic and Monetary Union (EMU) is part of the European Union (EU), and at the same it is an instrument aimed at achieving stable economic growth and low inflation, which is the main objective of the EU economic policy. The European EMU is based on a single monetary and coordinated economic policy. This single monetary policy would be impossible without the attainment of a coordinated fiscal policy and without the free movement of capital, goods, and services within the single European market. The foreign exchange regime is a major problem of the EMU. Before its accession to the EU, each country has the right to choose its own foreign exchange regime as long as it contributes to the fulfillment of the Copenhagen criteria. After acceding to the EU, monetary policy becomes a matter of common interest. In compliance with the Treaty establishing the European Community (ECT), the European Commission (EC) has bound *the adoption of the Acquis Communautaire for the EMU with three clearly outlined phases* (European Commission, II/384/99-EN, 1999):

- **A pre-accession phase**, which is the phase that Bulgaria is in at the time being;
- **An accession phase**, which covers the period from the accession to the adoption of the single currency. During this phase each member-country of the Union will have the status of a country with derogated participation in the Euro-zone and will have to observe the targets of the economic and monetary union;
- **A final phase** of Euro-zone membership, which depends on the attainment of the Maastricht criteria and on a country's capability to meet the conditions for adopting the single currency. This capability is established on the basis of inspections as per Art.122 (2), testifying to the high degree of stable convergence (European Commission, II/384/99-EN, 1999) in compliance with the criteria described in Art. 121 (1) of the ECT.

During the first pre-accession phase, which is of particular interest for Bulgaria, the countries are to carry out economic reforms in order to achieve economic stability and high economic growth. Accordingly, they pursue a policy conducive to the attainment of the Copenhagen criteria, at the same time harmonizing their legislation in compliance with the requirements for membership in the EMU with derogated participation in the Euro-zone. According to the Copenhagen criteria, the country willing to accede to the EU should, as early as this stage, adhere to the objectives of the political, economic, and monetary union. In more concrete terms, the pre-accession phase raises the following requirements (European Commission, II/384/99-EN, 1999):

- Completion of the deregulation efforts concerning the movement of capital – Art. 56 of the ECT;

- Ban on any kind of direct public sector financing by the Central Bank (CB), as well as a ban on any privileged access to financial institutions on the part of the public sector – Art. 101 and Art 102 of the ECT;
- Harmonization of the Central Bank Act, in this particular case the Bulgarian Central Bank Act, with the ECT in compliance with Art. 108 and 109.

The pre-accession phase does not require that the countries, candidates for EU accession, should observe the Maastricht criteria as they are mandatory only for the EU member countries. The candidate countries in the process of accession are obliged to meet the Copenhagen criteria only. Nevertheless, observing the Maastricht criteria is important, because it secures the stability of the countries, which have applied for EU membership.

The Maastricht criteria are divided into two categories: criteria concerning price approximation, and fiscal criteria. The first type of criteria refers to achieving a low inflation rate and low interest rates, whereas the second type of criteria imposes restrictions on the budget deficit and the government debt. The attainment of low inflation and a balanced budget excludes abrupt fluctuations in the balance of payments, i.e. in the movement of goods, services, and capital, and consequently leads to the stability of the foreign exchange rate, which is the fifth Maastricht criterion. The ability to meet all the Maastricht criteria prepares the EU member-countries for accession to the Euro-zone.

The Regular Report on the Progress Made by Bulgaria

The Regular Report emphasizes that upon its accession to the EMU, Bulgaria will have the status of a country with derogated participation in compliance with Article 122 of the ECT. The requirements, which Bulgaria has to observe with respect to the EMU, are those typical for the pre-accession phase. The comparative analysis of the current state of the Bulgarian legal framework and the requirements of the ECT as regards the independence of the Central Bank indicate that, at the time being, Bulgaria has achieved a significant degree of harmonization of its legislation with the requirements of the EMU Acquis communautaire, taking into consideration the pre-accession stage the country is in at present.

Independence of the Central Bank

Comparison between the ECT and the Bulgarian Legislation

ECT Requirements	Bulgarian Legislation
Art.108 and Art. 109 of the Treaty for the Establishment of the European Community and Art. 7 of Protocol 3 concerning the Charter of the European System of Central Banks (ESCB) and the European Central Bank (ECB) prevent a Central Bank or individual members of its bodies, who are in a decision-making capacity, from being given instructions or being influenced in any way by the national government, the European Union institutions or any other authorities.	According to the **Bulgarian National Bank Act (BNBA)** the *BNB is independent from any government agencies and authorities*. **Art. 44 of the BNBA** explicitly states that the BNB is independent from any instructions issued by the Council of Ministers or any other government agencies while performing its intrinsic activity. The fact that in accordance with **Art. 3 of the BNBA**, the BNB and the Council of Ministers inform each other about their intentions and actions when the general outlines of monetary and lending policy are determined, does not infringe in any way the independence of the CB; this only creates the possibility to achieve better coordination between the autonomous CB and the agencies of the executive branch of power.
The independence of the CB does not rule out, on the contrary – it presupposes the transparency of the Bank's activity through presenting annual reports. An example to this effect are the annual reports of the ECB on the performance of the ESCB submitted to the European Parliament and the European Council.	**Art.1, Para. 2 of the BNBA** requires that the BNB report to the National Assembly. Regardless of the fact that the BNB is required to report to the National Assembly, the principle of the CB independence is not abused, because the parliamentary control carried out during question time excludes any mandatory instructions being given to the CB in connection with the policy it pursues and the work it does. **Art. 50 of the BNBA** requires that the BNB submit a report about the preceding period twice a year, and **Art. 51** requires that the CB submit an auditor's report and BNB budget to the National Assembly.
Art. 101 of the ECT and Art. 21 of Protocol 3 forbid the extension of an overdraft or any other type of credit to the central government by the CB. The direct purchase of government debt instruments by the CB is also forbidden.	As per **Art. 45 of the BNBA**, **the BNB** cannot extend loans in any form to the government or government institutions with the exception of loans at the expense of SDR purchased from the International Monetary Fund (IMF), which are granted on a decision

by the CB is also forbidden.	made by the BNB's Board of Directors.
Art. 102 of the ECT provides that no privileged access should be given to the central government, the municipalities or other public institutions to any financial institution.	There is no Act in the Bulgarian legislation providing for such privileged access on the part of the Bulgarian government, the municipalities, or any other public institutions to the financial institutions.
Art.14.2 of Protocol 3 concerning the Charter of the ESCB and the ECB requires that the term of office of the Governor should not be shorter than a 5 years' period of time. The Governor can be ousted from office only when he no longer meets the conditions and is incapable of performing his duties, or when he is accused of mismanagement or poor administration.	**BNBA (Art. 12 and Art. 14, Art. 17**) refers to the election and independence of the Board of Directors of the BNB. It envisages that the Governor and Vice Governors of the BNB shall be elected by the National Assembly, their term of office being of a 6 years' duration. The Governor and the rest of the members sitting on the Board of Directors can be removed from office before their term of office has expired if the conditions, which have given rise to their election have been infringed, as well as when they fail to take part in three or more consecutive meetings of the Board of Directors without a sufficiently good reason, or when a significant infringement of their official duties occurs, either through action or inaction, which prevents them from fulfilling the tasks they have been entrusted with by the BNBA (**Art. 14 of the BNBA**).

Source: Regular Report on the Progress Made by Bulgaria, 2000

After the exchange rate was pegged to the German mark within the framework of the Currency Board arrangement, Bulgaria has marked significant progress in abating inflation by curbing the inflation rate, achieving a widely balanced government budget and low and relatively stable interest rates. In order to retain the results achieved and to avoid the risk of speculative attacks and infringement of the financial discipline, Bulgaria would like to preserve the Currency Board agreement up to the moment it accedes to the EU, and possibly to the time it joins the EMU. A similar strategy is pursued by the other countries practising a fixed exchange rate regime or a currency board arrangement which have applied for EU membership, such as Estonia, Latvia, and Lithuania. In this respect the Regular Report on Bulgaria underlines that Bulgaria maintains a Currency Board arrangement and observes a strict monetary policy, foreign exchange and fiscal discipline, ruling out any direct financing of the public sector on the part of the Central Bank. The Regular Report on Bulgaria pays special attention to the progress made with respect to economic policy coordination, the flexibility of its fiscal policy and the mechanisms concerning the management and control of expenditures. It explicitly stresses upon the fact that the administrative capacity of the BNB, the Ministry of Finance, and the Council of Ministers has been enhanced. The overall assessment given to Bulgaria with respect to the application of the Acquis in the EMU sphere is that "satisfactory progress" has been achieved.

Comparison between Bulgaria, Lithuania, Latvia, and Slovakia

Bulgaria	Latvia	Lithuania	Slovakia
Bulgaria has marked **satisfactory progress** with respect to the EMU Acquis implementation, including also economic policy coordination, fiscal policy flexibility, and mechanisms for better management and control of expenditures. Bulgaria maintains a Currency Board arrangement and observes strict monetary policy, foreign exchange and fiscal discipline, and independence of the monetary authorities, and rules out any direct financing of the public sector on the part of the Central Bank.	Latvia has adopted **a significant part of the Acquis** concerning the EMU. The Latvian legislation is harmonized with the Acquis requirements for a ban on direct financing of the public sector by the Central Bank and privileged access of the public sector to financial institutions. The Latvian Central Bank Act guarantees the independence of the CB.	Lithuania has adopted a **significant part of the Acquis** concerning the EMU. Further progress is necessary with respect to the independence of the Central Bank and the members of its Board of Directors, as well as in relation to the ban on direct financing of the public sector by the Central Bank.	**A considerable effort is needed to harmonize the country's legislation with the Acquis** concerning the EMU and with respect to the independence of the Central Bank and the ban on direct financing of the public sector. The legislation of the country does not contain an explicit provision for privileged access of the public authorities to funding by financial institutions.

Source*:* Regular Report on Bulgaria, 2000

The comparison between the Regular Reports on Bulgaria, Latvia, Lithuania, and Slovakia – countries from the Helsinki group, three of which have introduced currency board or fixed exchange rate arrangements – indicates that Bulgaria and Latvia have registered the most positive progress with respect to the harmonization of their respective legislation with the Acquis concerning the EMU at the pre-accession stage. The regular reports note that these countries have achieved the independence of their central banks and that funding of the public sector on the part of the central banks has been ruled out. Unlike them, Lithuania and Slovakia have not met the requirements of the Acquis concerning the EMU. Irrespective of all this, the Regular Report gives Bulgaria a modest evaluation summarized by the expression "satisfactory progress".

The comparison of the concrete recommendations contained in the Regular Reports on each of the four countries confirms the fact that the satisfactory achievements made by Bulgaria have resulted in a considerably smaller number of recommendations about the adoption of the Acquis in relation to the EMU.

Recommendations about the adoption of the Acquis in relation to the EMU

Bulgaria	Latvia	Lithuania	Slovakia
What is needed is: • To amend the BNBA concerning the composition of its Board of Directors; • To improve the comparability and quality of budget data.	What is needed is: • To bring the definitions about the consolidated government debt in line with EU requirements.	What is needed is: • To secure the personal independence of the members of the Board of Directors of the CB; • To modify the reporting procedure before Parliament with a view to consolidating the independence of the CB; • To pass a law which forbids the direct funding of the public sector by the CB.	What is needed is an amendment to the Central Bank Act with the purpose of: • To discontinue the direct short-term financing of the government; • To secure the complete functional, institutional, personal, and financial independence of the CB.

Source*:* Regular Report on Bulgaria, 2000

What impresses here is that the most serious recommendations about the independence of the Central Bank are addressed to Lithuania and Slovakia. The recommendations addressed to Bulgaria and Latvia are mostly of a technical nature. This is an additional proof to the fact that Bulgaria has achieved a better degree of harmonization between its legislation and the requirements of the Acquis at the pre-accession phase.

The comparison between Bulgaria, Latvia, and Lithuania with respect to certain major economic indicators, which outline the economic stability of the countries and their potential capacity to maintain a fixed exchange rate or a currency board arrangement, shows that Bulgaria's indicators about the budget deficit and the current account deficit as a percentage of the GDP are considerably more favourable than the same indicators for the other two countries (Table 1). In this respect the Regular Reports on Latvia and Lithuania recommend that their budget and current account deficits be decreased because if they are not brought under control, the stabilizing effect of the currency board or fixed exchange rate arrangement could be compromised.

Table 1. Selected Indicators, 1999

Indicators	Bulgaria	Latvia	Lithuania
Inflation – average annual percentage rate	2.6	2.4	0.8
GDP in percentage terms	2.4	0.1	- 4.1

Budget deficit/GDP in percentage terms	- 0.9	- 3.8	- 8.6
Current account deficit/GDP in percentage terms	- 5.3	- 10.6	- 11.2

Source: the European Commission

At the present stage Bulgaria is under no obligation to meet the Maastricht criteria with respect to the budget deficit (which require that it should not exceed 3% of the GDP) and the consolidated government debt (which should not exceed 60% of the GDP); nevertheless the ratio of the budget deficit to the GDP was about 1% in 1999, and about 1.5% in 2000. This year's budget policy of Bulgaria is determined by the Government Programme and the IMF Agreement Programme of the country. The two programmes are focused on achieving fiscal stability through maintaining a broadly balanced government budget on the basis of an improved tax collection rate, control over non-interest related expenditures, and observing strict budget discipline. As to the consolidated government debt, the new Draft Bill on the government debt is based precisely on the EU definitions about the consolidated government debt and lays down requirements directed to its gradual decrease as a percentage of the GDP in accordance with the Maastricht criteria.

Accession through the preservation of the Currency Board arrangement

The standard scenario for joining the EMU envisages that a country should have already become a EU member country; it should have attained the Maastricht criteria, the countries operating under a currency board arrangement should have given it up it and should have restored the central bank's instruments of monetary policy; they should also observe the ERM2 requirements, should have joined the Euro-zone and should have introduced the Euro as the domestic currency of their country. The accession to the EU is only possible after the Copenhagen criteria have been attained, whereas the membership in the EMU is based on the attainment of the Maastricht criteria. The standard approach to joining the EMU also requires that all EU member countries which subsequently join the EMU should have harmonized their legislation in the area of fiscal and monetary policy, should have achieved the coordination of their fiscal and monetary policy by observing the Maastricht criteria, and should maintain a balanced budget.

Because of the fact that the requirement for joining the EMU were adopted before opening negotiations with the countries in transition, some of which operate under a currency board arrangement, the ECB and ECFIN were obliged to discuss some alternative approaches to joining the EMU and the Euro-zone. Subject to discussion were scenarios, which are an alternative to the standard scenario for joining the EMU and which make room for the possibility of accession directly with an existing currency board arrangement (this refers to countries such as Bulgaria and Estonia), or even by means of a unilateral euroization (Estonia does not rule out such a possibility) (Eesti Pank, Different Views on the Euro, 2000). The ECB has been considering the possibility of allowing deviations from the standard scenario for the countries operating under a currency board arrangement and permit the retention of the currency board during the ERM2 period. In the opinion of the IMF, the currency board arrangement is a framework compatible with the ERM2 requirements (Keller, P. 2 000, Gulde, A-M., J. Kahkonen, P. Keller, 2000). At present, discussions are being held among economists about the possibility for officially allowing unilateral euroization as a theoretical opportunity for joining the Euro-zone. Euroization does not necessarily mean that all criteria for the joining the EMU should have been met, and this respectively means that the full EMU membership is not mandatory either.

It should be noted that under all possible scenarios the attainment of the Maastricht criteria, i.e. the nominal approximation, should be preceded or accompanied by genuine approximation. This means that the countries must have attained a level of real incomes that does not differ significantly from the average for the Euro-zone.

The willingness, which Bulgaria has already expressed to preserve the currency board arrangement up to the time it joins the EU and possibly the EMU, means that the country will join the EU and will fulfill the Maastricht criteria without fully restoring its central bank and its respective instruments. If the currency board arrangement should be preserved, the ERM2 stage could be reduced to allowing for minimum foreign exchange fluctuations within the limits of +/- 0.5%, which are permissible for instance in accordance with the BNBA, instead of the +/- 15% fluctuations permissible according to the ERM2.

The possibility to preserve the currency board arrangement in the run-up to the accession to the EU and the EMU could be admitted not in principle, but for each country individually, depending on the fulfillment of concrete conditions and on the conclusion of an agreement about the central exchange rate in relation to the Euro. This possibility could be admitted first of all for well functioning currency board arrangements, in the absence of a markedly overvalued real exchange rate, in the conditions of a balanced exchange rate, flexible labour market, prudent fiscal policy, conservative policy in relation to foreign indebtedness, stable banking system, etc. (Keller, P. 2 000, Gulde, A-M., J. Kahkonen, P. Keller, 2000).

The IMF studies on the issues of Bulgaria's competitiveness and the overvaluation of the real exchange rate come to the conclusion that the overvaluation of the real exchange rate observed from the middle of 1997 to the beginning of the year 2000 is insubstantial in comparison with the overvaluation in other countries in transition and can be linked to a large extent with the Balassa-Samuelson effect (IMF Staff Country Report N00/54). This effect presupposes the more rapid growth of productivity in the sector of non-traded goods and services. Other factors, which could explain the overvaluation of the exchange rate are price liberalization, changes in the capital inflows, and government expenditures. As to minimum and average wages, in US dollar terms they are among the lowest in the region. For comparison's sake, according to IMF data the 1999 average wage in Bulgaria was $117, while it exceeded $290 in Estonia, $260 in Latvia, and $400 in Poland. The average wage in Rumania was $128. Labour productivity growth in Bulgaria helped unit labour costs to remain unchanged in dollar terms during the last several years. If no drastic changes take place in the external environment that differ from the forecasts, and if Bulgaria continues to pursue its current reasonable economic policy, i.e. conservative fiscal policy and prudent incomes policy in state-owned enterprises, the stability of the currency board arrangement and the competitiveness of the economy will be preserved in the medium-term perspective (IMF Staff Country Report, N 00/53).

The major challenge for every currency board arrangement is to secure and maintain a sufficiently large foreign exchange reserve that can guarantee its stable functioning. In meeting its needs for foreign financing, Bulgaria is strongly dependent on the influx of foreign investment (about 50% in 1999) and on loans in support of the balance of payments from the international financial institutions (38% in 1999) (Ulgenerk, E. and L. Zlaoui, 2000). From the inception of the currency board arrangement to the present date, Bulgaria has been receiving financial assistance in support of its balance of payments from the international financial institutions (IFI), the amount of which exceeds US$ 400 – 450 millions annually.

The current account of Bulgaria's balance of payments has marked a deficit ever since 1998 and this trend did not mark a reversal in the year 2000 either. In 1999 and 2000, direct foreign investments succeeded in financing the current account deficit, and in 2001 the expectations are for this deficit to decline below the 2000 level as a percentage of the GDP. In the medium term, with the completion of the privatization of large-scale enterprises, Bulgaria will find it increasingly more difficult to rely on big revenues from privatization deals. If the investment climate fails to improve so that fresh foreign investments can be attracted, it would be difficult to expect any significant growth in investments. Regardless of the fact that Bulgaria generates stability in the region, it is more likely that the process of attracting foreign investments in future will continue to depend on the unattractive image of the Balkans as a region of political, economic, and ethnic instability.

During the next several years, with the completion of privatization deals and given the relatively large sums of money, amounting to more than US$ 1 billion a year, that will go to the repayment of the foreign debt, an adverse development of the balance of payments can be expected if the "green field" investments in the country remain at a modest level. In 2001, Bulgaria can still rely on the financial support of the IMF. A problem will occur in the following years, should the government fail to conclude a new agreement with IMF and the investment climate in the region fail to offer favourable conditions for the attraction of foreign investments. For a certain period of time, the larger foreign debt repayments could be financed out of the foreign exchange reserves of the BNB, but the stable functioning of the currency board arrangement would require that the reserves be preserved at a relatively high level. The country's reliance on the financial support of the IFI or on the issuance of Euro-bonds or government securities is limited in the final analysis by the need to reduce the consolidated government debt and effect the approximation with the Maastricht criterion concerning the ratio between the consolidated government debt and the GDP.

If Bulgaria decides to preserve its currency board arrangement in future, and also its current policy of strict financial discipline and incomes policy in state-owned enterprises, and if it continues to enjoy the necessary support on the part of the international financial institutions or succeeds in securing an alternative source of financing to fund its potential balance of payments deficits, it can be expected that the problems, which remain to be solved so that the currency board arrangement and the fixed exchange rate remain free of possible risk, are as follows: increasing the flexibility of the labour market, continuation of the processes of restructuring state-owned enterprises, attraction of foreign investments and improvements in the management of the consolidated government debt. The issue concerned with the increase of the Bulgarian economy competitiveness and the establishment of a favourable climate for the attraction of foreign investors to the country is and will continue to be a key issue in the future, too. The solution of this issue will help the country overcome the difficulties with respect to the balance of payments and will inevitably create prerequisites for achieving higher economic growth rates and increasing real incomes, so that Bulgaria can shorten the distance between its current incomes level and the average real incomes level for the Euro-zone. What should be done to attain this purpose is to overcome the bureaucratic procedures, raise the quality of public services, and strictly implement the respective legislative acts.

January, 2001

Literature:

Bulgarian National Bank Act, 1991 and 1997

Consolidated Government Budget Act, 1996

Government Debt Act, (Draft Bill 2000)

Berg, Andrew and Eduardo Borensztein, 2000, The Dollarization Debate, *in Finance & Development, IMF*, March 2000.

Berg, Andrew and Eduardo Borensztein, 2000, The Pros and Cons of Full Dollarization, *IMF Working Paper*, WP/00/50

Bulgaria: Selected Issues and Statistical Appendix, 2000, *IMF Staff Country Report No 00/54*

Bulgaria: Staff Report for the 1999 Article IV Consultation and Third Review Under the Extended Arrangement, 2000, *IMF Staff Country Report N0 00/53*

Consolidated Version of the Òreaty Establishing the European Community, 2000

Eesti Pank, 2000, Different Views on the Euro: Definitions, Economic Policy Issues and Upcoming Tasks, 2000, www. Ee/epbe/en/EU_euro.html

European Commission, Directorate General, 1999, Economic and Financial Affairs, Accession to the EU and Implications for EMU, Brussels, 25 June, 1999, II/384/99-EN

European Commission, Directorate General, 2000, Economic and Financial Affairs, The Pre-accession Fiscal Surveillance Procedure, Brussels, 27 March, 2000, D 2000

Gulde, Anne-Marie, J. Kahkonen and P. Keller, 2000, Pros and Cons of Currency Board Arrangements in the Lead-uo to EU Accession and Participation in the Euro Zone, *IMF Policy Discussion Papers,* PDP/00/1

Keller, P., 2000, Recent Experience with Currency Boards and Fixed Exchange Rates in the Baltic Countries and Bulgaria and Some Lessons for the Future, IMF.

Protocol (N0 3) on the Statute of the European System of Central Banks and of the European Central Bank

Protocol (No 5) on the Excessive Deficit Procedure